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Lease Transfer Issues in the Wake of Recent Chapter 11 Retail Bankruptcies

Shopping center owners have experienced a flood of paper in the recent bankruptcy filings. **Tenants like RadioShack, A&P, Sports Authority, and EMS are just some recent big retailers filing for Chapter 11 bankruptcy protection.** Some of the reasons for filing include economic and demographic factors like tenant "right-sizing" between bricks and mortar, lower margins, and chasing Millennial dollars.

In retail tenant Chapter 11 proceedings, debtors try to maximize their business value by restructuring debt and operations. In some cases, debtors assume leases and continue with operations through a successful Chapter 11 reorganization. Other debtors transfer leases to another economically viable tenant via an auction or sale within the bankruptcy. Alternatively, other tenants may simply reject leases, leaving vacant space. Landlords can face a Chapter 22 (two Chapter 11 proceedings on the heels of each other, like the A&P bankruptcy cases), where in the first case a lease is assumed, but in the second, the lease is rejected.

Besides payment, most landlords' primary concern is how the lease will be transferred in the bankruptcy (i.e., will it be assigned, assumed, rejected?).

Termination of Lease

Debtors can only transfer (sell, assign and/or reject) a lease, if it's not terminated prior to bankruptcy. Owners may try to get a jump on a tenant heading to bankruptcy by defaulting and terminating the lease, to cut off any rights prior to filing. These efforts may bring the lease current, but it could also lead to a walk-away, leaving landlord vacant space and possibly payment of only pennies on the dollar.

Recent case law may give owners pause before calling a default and/or terminating prior to bankruptcy. In In re Great Lakes Quick Lube, LLP, a creditor's committee brought an action against a landlord under Bankruptcy Code §§ 547(b) and 548(a)(1) to recover lost value of leases terminated pre-bankruptcy. The court held to the action to find two (2) profitable of five (5) leases, terminated pre-bankruptcy, could proceed. Meaning, the landlord may have to give money back (the value of the leases) to the Debtor for the two (2) profitable leases.

The appellate court remanded the case to the original Bankruptcy Court to determine: 1) if there was any value in the two (2) leases; and, 2) if so, are there are any defenses. In the interim, owners should ensure terminations are properly documented. For instance, savvy owners may provide a stipulation that there is little or no value and that in consideration of termination, landlord waives some value.

Owners may try to terminate the lease post-bankruptcy. Most leases provide a tenant bankruptcy filing is a breach and cause for termination. Unfortunately, these provisions are Ipso Facto - unenforceable in federal bankruptcy court. One reason to still include the provision is if there are guarantors, then the provision can be enforced against guarantors, so long as they are not in bankruptcy.

Post-filing, debtors are required to keep landlords' rent current and all other obligations, while they use the space. Debtors have 120 days to assume and/or assign leases, or else they are rejected, per Bankruptcy Code §365(d)(4). Although Debtors can request a 90-day extension for "cause," filing such a motion can open up issues, such as payment of stub rent and/or viability of the case itself – issues debtors may not want to address. Still, if landlords are not being paid or a covenant default exists (change of use, dark store, etc.) landlords can move to reject the lease. Post-bankruptcy arrears while debtors operate are treated as priority administrative expense claims, paid ahead of other creditors. Like any pre-termination efforts, it is wise to properly document the same.

Assumption/Assignment of Lease

Any lease assumption and/or assignment must take the lease under its terms, unless modified by consent. This includes paying all arrears, as well as following terms of use. However, attorney's fees may not be collectable, if not properly defined. For instance, if the lease says counsel fees are allowed if there is a default, and landlord is current at filing, then counsel fees may be barred. Have counsel advise upfront on the ability to collect these fees, as well as efforts to avert this issue.

Often, an auction will be held within the first 120 days to dispose of leases by assigning to another tenant or, in some cases, sell all leases. With auctions, debtors arrange bidding procedures, which may allow landlords to credit bid their arrearage, attend the auction and receive adequate assurance packages for bidders. If these provisions are not provided in the bid procedures, landlords should demand the same, or face a lease transferred to a tenant that violates use conditions, causes cross-defaults within the center, and/or does not meet basic financial conditions.

Prior to auction, debtors may request to modify the lease, making it more attractive. Debtors can request lower rent, extension options, change use and/or reduce space. An above-market lease may be a difficult sell, so modification may be advantageous. One tip with modification is to add a voiding/expiration, if there are no lease bidders. However, if the space is valuable, modification may not be worthwhile. If guarantors also filed for bankruptcy, the landlord may want to condition new guarantors for adequate assurance purposes. This occurred for many landlords in the Joyce Leslie case, where leases were assigned to separate LLCs with a parent guarantying.

Rejection of Lease and Store Closing

Lease rejection automatically terminates the leasehold and returns it to landlord. However, debtors cannot just state that rejection occurred and hold back turning over. They must not only reject, but provide the space to landlord. If not, the landlord can assert the lease is still valid and request administrative expense claims. Debtors usually file rejection and store closing procedures motions early to address these issues. These motions usually concern signage placement, sidewalk sales, walkers and hours of operation. As such, it is important with any rejection and store closing motion to communicate with internal operations and leasing personnel. Operations wants to ensure with store turnover they have security codes, HVAC and utility information. Leasing wants to know when new tenants can be placed in the space.

Ensuring this information can avoid real-world issues like operational health and safety concerns and space availability on the leasing side. Further, landlords should inspect the space prior to rejection and turnover to note damages, as well as fixtures and debtor equipment. In some supermarket cases, landlords who did not conduct walkthroughs prior to turnover suffered stripped copper and/or missing turnkey fixtures, which lowered lease values. Counsel should assert objections, if not adequately addressed.

Get Counsel Involved Early On

These recent Chapter 11 retail filings happen fast and are often over quickly if the debtors' efforts are successful. Many of the important motions are filed and heard within the first two months. Knowing your rights and deadlines are key to mitigating against risk.